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To: Arthur Levitt, Jr. (Co-Chair)
Donald T. Nicolaisen (Co-Chair)
Advisory Committee on the Auditing Profession

From: Dana R. Hermanson
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Re: **Comments for October 15th Meeting**
"The Incompatibility of Auditing and Consulting Services"

I would like to thank the Committee Co-Chairs and members for their willingness to examine the sustainability of the auditing profession. As a former Big 4 auditor and now an auditing researcher and educator, I greatly appreciate your concern for the future of the auditing profession.

As the Committee begins its deliberations, I believe one critical issue should be very carefully considered – the incompatibility of auditing and consulting services. Recent media coverage indicates that the large auditing firms are rapidly rebuilding their consulting practices, just a few short years after the major accounting scandals. I fear that, even with the provisions of Sarbanes-Oxley in place, the re-emergence of consulting poses a significant threat to long-term audit quality. In fact, I would go so far as to say that consulting services pose a significant threat to the long-term sustainability of the auditing profession in the private sector.

Background

As accounting statesman Arthur Wyatt so eloquently describes in his 2004 *Accounting Horizons* article (which should be required reading for all Committee members), the nature of the large audit firms changed dramatically in the years leading up to the accounting scandals.[1] During the 1980s and 1990s, consulting services represented an ever-larger portion of the large audit firms' revenues. The firms' focus shifted from professionalism and technical accounting and auditing expertise to revenue generation and rewarding the "rainmakers." The scope of audits decreased markedly as firms looked

[1] Wyatt, A. 2004. "Accounting Professionalism – They Just Don't Get It!" *Accounting Horizons* (March): 45-53.

for ways to reduce costs, and many in public accounting viewed the audit as a commodity or loss leader. Many parties expressed concern that audit firms were driven by consulting, not by auditing. The once noble accounting *profession* had become a *business*.

In response to the accounting scandals of 2001-2002, the Sarbanes-Oxley Act prohibited audit firms from providing many consulting services to their audit clients. This effort was designed to promote more independent audits. At that time, most of the large auditing firms divested their consulting arms, a move that was applauded by many observers who hoped the audit firms would go back to focusing on auditing and would forever abandon their fixation with consulting services.

Disappointingly, a recent article in *BusinessWeek* notes that the Big 4 audit firms now are racing headlong back into the consulting world, dazzled by the high margins and plentiful business opportunities.[2] The article cites statistics from Kennedy Information Inc. indicating that in 2006 the Big 4 collectively earned over $20 billion in revenues from consulting, led by Deloitte's $8.9 billion (45% of the firm's global revenues). Three of the Big 4 firms' consulting revenues grew by 12% or more from 2005 to 2006. Clark Beecher of Magellan International states, "It's the old mentality again. You sell everything you can." The article also notes that Deloitte has created a single profit pool to be shared by auditors, tax accountants, and consultants.

The Incompatibility Issue

What is the problem with consulting services if they are not provided to the firms' audit clients? As highlighted by Mr. Wyatt, the rise of consulting services in recent decades had an extremely detrimental effect on the culture of the large audit firms, and ultimately a significant negative impact on audit quality (p. 50):

> *In essence, the culture of the leading firms in the profession had changed. New personnel who lacked a background that placed prominence on accounting professionalism gradually gained increasing influence in accounting firms. The consulting arms were rapidly growing and were gaining higher compensation levels than the audit and tax partners. The leaders of the audit and tax practices felt increasing pressure to grow revenues rapidly and, more importantly, to grow profit margins in their service areas. Those with a facility to sell new work advanced more rapidly . . . Those with the technical skills previously considered so vital to internal firm advancement found themselves with relatively less important roles . . .*
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> *Primarily commercial interests had undermined the core values of the professional firm. The issue was not how the delivery of a particular consulting service might affect the auditors' judgment . . . The issue was how the increasing infusion of personnel not conversant with, or even appreciative of, the vital importance of delivering quality accounting and audit service affected the internal firm culture, its top-level decisions, and the behavior patterns of*

[2] Byrnes, N. 2007. "The Comeback of Consulting." *BusinessWeek* (September 3): 66-67.

impressionable staff personnel. It wasn't that consulting personnel were unprofessional in performing their work, it was that their actions and behavior were far more commercially driven than would be acceptable for audit personnel. The consultants did not focus on investor or creditor interests, and their attitudes gradually affected how auditors approached their work. Auditors were more willing to take on additional risk in order to maintain their revenue levels. Many long-standing audit procedures that put audit personnel in touch with recurring transactions were scaled back . . . Healthy skepticism was replaced by concurrence. The audit framework was undermined, and the result was what we have recently seen in massive bankruptcies, corporate restructurings, and on-going litigation.

Consistent with Mr. Wyatt's insights, a fundamental issue in large audit firms is, "Who runs the firm?" If consulting represents a large portion of firm revenues and profits, then the consultants really run the firm, consistent with the old adage, "He who has the gold makes the rules." The consultants potentially can drive the firm's culture toward commercialism and away from accounting professionalism.

Based on Mr. Wyatt's assertions, the power held by the consultants can damage audit quality in a number of ways:

- The leaders of the firm may have little understanding of or regard for accounting professionalism and protection of the investing public. The culture of the firm may no longer be consistent with accounting professionalism.
- The reason for the firm's existence may become unclear. The firm may move from existing to provide auditing services to existing to provide a broad range of services, one of which happens to be auditing.
- The identity of the firm's client may become unclear. The client may shift from the investing public (in the audit realm) to company managers (in the consulting realm).
- The auditors and consultants may expend considerable effort arguing about compensation and profit sharing, since consulting often is a higher-margin business. Such internal squabbles can take energy away from providing quality auditing services.
- The auditors may feel pressure to cut costs on their audits so as to make their profits more comparable to those of the consulting partners.
- The reward system within the firm may focus too much on revenue and profit generation and not enough on technical ability and accounting professionalism.

By analogy, consider an orthopedic medical practice with a very strong commitment to quality medical care and medical professionalism. Would it make sense for this medical practice to expand its service lines (and personnel) to include massage therapy, hair replacement services, and a nail salon? There is nothing sinister about these other service lines or about people who provide such services; however, it would be ridiculous to house them in an orthopedic practice. The fundamental nature of the services is incompatible with the medical profession, and only medicine is a *profession*. The other services represent *businesses*, and a business should not be housed with a profession. If this does occur, the profession is almost sure to be diluted by the business.

Conclusion

Even though the Big 4 firms are no longer performing consulting services for their own audit clients, I believe the resurgence of consulting services poses a serious threat to long-term audit quality because of its impact on firm culture and incentives. I hope the Big 4 CEOs will learn from history and resist the temptation to build giant consulting firms.[3] The financial markets need credible, high-quality audit firms – not large consulting firms that happen to provide auditing services. If the firm leaders continue their race toward consulting, I fear that following the next wave of audit failures, the auditing profession will cease to exist in the private sector, leaving us with government-run audits.

I strongly encourage the Committee to read Mr. Wyatt's 2004 article and to fully consider the incompatibility of auditing and consulting services. Audit firms need to focus on their statutory role of providing credibility to financial reports. I believe that consulting services detract from this role and may lead the auditing profession to oblivion.

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[3] Consistent with this concern, the September 3rd *BusinessWeek* article quotes Tom Rodenhauser of Kennedy Information Inc., "[H]ave you learned your lesson or is this going to turn out badly again?"